

Internal Revenue Service
memorandum

CC:FS:P&SI
TJKANE/lmr

date: NOV - 8 1991

to: District Counsel, Denver CC:DEN
Attn: David P. Monson

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [REDACTED]
Application of Rev. Rul. 72-221
TL-N-864-92
CC:FS:P&SI Kane Wilson
I.R.C. § 47

This is in response to your request for Field Service Advice dated October 24, 1991.

ISSUE

Whether the recapture provisions of I.R.C. § 47, as illustrated by Revenue Ruling 72-221, 1972-1 C.B. 15, involve a method of mechanically computing the amount of recapture tax liability upon the early disposition of section 38 property in the year of such disposition, or does the calculation of recapture tax liability under I.R.C. § 47 involve an actual carryback and carryforward of unused investment tax credits in determining the amount of recapture tax liability in the year of disposition?^{1/}

CONCLUSION

We believe that the calculation of recapture tax liability under I.R.C. § 47 is mechanical in nature, involving only a mathematical computation in the year of an early disposition of section 38 property, and does not involve the actual carryback and carryforward of unused investment tax credits. Therefore, in

^{1/} All references to the Internal Revenue Code and regulations thereunder relate to the provisions as they existed during the years in question.

computing its recapture tax liability for the years [REDACTED] through [REDACTED], it would appear, based on the information submitted to us, that [REDACTED] (" [REDACTED] ") is not in violation of the settlement agreement entered into during the course of its bankruptcy proceedings.

FACTS

On [REDACTED], [REDACTED] filed a petition in bankruptcy court pursuant to chapter 11 of the Bankruptcy Code. The Internal Revenue Service filed proofs of claim in the proceeding. In [REDACTED], [REDACTED] filed a motion requesting an estimation hearing to determine the allowed amount of the Service's claim. An estimation hearing was held and an opinion adverse to the government was issued by the bankruptcy court. A settlement of the estimation proceeding was subsequently reached between [REDACTED], the Department of Justice, and the Service. The settlement was a comprehensive settlement of [REDACTED]'s fiscal years [REDACTED] through [REDACTED].

Paragraph 7 of the settlement agreement states, in pertinent part, that:

[A]ny [REDACTED] credits and any net operating losses or credits of [REDACTED] generated in the fiscal year ended [REDACTED] or subsequent years shall be carried forward and shall be available as permitted by the Internal Revenue Code to [REDACTED] in future years notwithstanding the fact that such net operating losses and credits would be available to be carried back to the years ended on or before [REDACTED] but for this agreement.

The obvious purpose of the settlement agreement with [REDACTED] was to determine an amount to be paid to the United States for the years [REDACTED] through [REDACTED] which, subject to the disallowance of a \$ [REDACTED] tentative net operating loss carryback from [REDACTED] to [REDACTED], would not change.^{2/}

^{2/} [REDACTED] incurred a net operating loss in [REDACTED] that was substantially in excess of the \$ [REDACTED] which was used for purposes of the settlement agreement. It was agreed to use \$ [REDACTED] because [REDACTED] was confident that at least that amount would withstand any challenge during the [REDACTED] audit. Thus, the settlement agreement carved out special provisions pertaining to the tentative carryback from [REDACTED] to [REDACTED] and the resulting consequences, none of which impacts the issued addressed herein.

During the years [REDACTED], [REDACTED] and [REDACTED], [REDACTED] disposed of section 38 property upon which investment tax credits had been claimed and allowed in the years [REDACTED] through [REDACTED]. On its tax returns for the years [REDACTED], [REDACTED] and [REDACTED], [REDACTED] reported the following ITC recapture and ITC recapture tax:

ITC Recapture:	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]
ITC Offset:	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]
Recapture Tax Paid:	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]

In determining the amount of the recapture tax, [REDACTED] relied upon the provisions of Rev. Rul. 72-221. By doing so, it "carried back" unused investment tax credits from [REDACTED] and [REDACTED] to the settled years and offset those credits against the amount of the recapture tax. [REDACTED] claims that, pursuant to Rev. Rul. 72-221, the "carrybacks" are only theoretical, and that the substance of its approach merely involved a mathematical recomputation for purposes of determining the recapture tax liability for the years at issue. The audit team has tentatively taken the position that the "carrybacks" at issue have substance, and, therefore, there has been a violation of the provisions of the settlement agreement.

DISCUSSION

During the years at issue, I.R.C. § 38 provided, among other things, a credit against income tax equal to a percentage of the amount a taxpayer invested in specifically qualified property. I.R.C. § 47(a)(1) provided that if a taxpayer disposed of the property which had been the basis for the investment tax credit before the close of its applicable useful life, then the tax for the year of the disposition shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years that would have resulted solely from substituting the actual useful life of the property to the taxpayer in place of the useful life taken into account by the taxpayer in the credit year.^{3/} See also Treas. Reg. § 1.47-1(a)(1).

^{3/} The term "credit year" means the taxable year in which section 38 property was taken into account in computing a taxpayer's qualified investment. See Treas. Reg. § 1.47-1(a)(1)(ii)(a).

The purpose of the recapture provisions of I.R.C. § 47 was described in the committee reports that accompanied the enactment of I.R.C. § 47 as part of the Revenue Act of 1962, Pub. L. No. 87-834:

To guard against a quick turnover of assets by those seeking multiple credit - - the bill provides (in sec. 47) a special adjustment. Under this provision if property is disposed of, or otherwise ceases to be section 38 property, the tax for the current year is to be increased by the reduction in investment credits (which would have resulted in the prior years) had the investment credits allowable been determined on the basis of the actual useful life of the property rather than its estimated useful life. * * *

Although the credit is recomputed for the earlier year in which the investment was made, the actual adjustment in tax occurs in the current year, namely, the year in which the asset is disposed of (or otherwise ceases to be sec. 38 property). This makes it unnecessary actually to recompute taxes in the prior years, or to extend the periods of limitations. An adjustment is also made in any carryovers of unused credits so that they too will reflect the reduced amount of investment to be taken into account.

* * *

Few exceptions are made in the adjustment rule for the credit described above because in no case does this result in a lesser credit than would be available had the useful life of the property been estimated accurately. Moreover, since the tax increase occurs in the current year, and not with respect to the prior year in which the investment occurred, no interest is charged with respect to the increase in tax resulting from the reduction in credit.

H.R. Rep. No. 1447, 87th Cong., 2d Sess. 13-14 (1962); see also S. Rep. No. 1881, 87th Cong. 2d Sess. 18 (1962) (substantially identical language with minor, nonsubstantive variations).

We believe that the legislative history quoted above provides the answer to your question. More specifically, the statement in the middle paragraph that "this makes it unnecessary to recompute taxes in prior years, or to extend the periods of limitations" fully supports the taxpayer's method of computation and your alternative analysis, at page 5 of your request for Field Service Advice, that the unused tax credit is not carried back to the earlier year, but is used in a purely mathematical sense to compute the amount of tax due in the recapture year.

I.R.C. § 47 provided that although the recapture tax under I.R.C. § 47(a) is to be added to a taxpayer's tax liability in the year of an early disposition of section 38 property, it is not a tax against which any investment credit earned during such taxable year can be credited. The relationship between I.R.C. §§ 47(a) and (c) was explained and illustrated by Rev. Rul. 72-221, which the taxpayer has cited as its authority for the manner and method of calculating the recapture liability for the years [redacted] through [redacted]. In order for Rev. Rul. 72-221 to come to a conclusion with respect to the illustration of the limitations of I.R.C. § 47(c), the revenue ruling had to initially address how the recapture tax liability is to be computed, which is the precise issue presented by your facts. We note that our analysis and conclusion reached herein, including our reliance on the legislative history quoted above, is entirely consistent with the analysis contained in G.C.M. 34,721 (December 23, 1971), which considered and approved Rev. Rul. 72-221.^{4/} Thus, although not explicitly stated in Rev. Rul. 72-221, it is clear that the revenue ruling has correctly incorporated the mathematical recomputation approach discussed by the legislative history under I.R.C. § 47(a).

^{4/} It is also entirely consistent with the analysis and conclusion reached in G.C.M. 39,648 (October 31, 1984), which considered and approved Rev. Rul. 87-56, 1987-2 C.B. 27 (minimum tax implications under I.R.C. § 56 analyzed in a situation involving investment credit recapture under I.R.C. § 47); see also T.A.M. 8425003 (undated) and Segal v. Commissioner, 89 T.C. 816 (1987).

If you have any questions concerning this issue, do not hesitate to contact Thomas J. Kane at FTS 566-3521.

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DANIEL J. WILES

By:



CURTIS G. WILSON

Chief,

Passthroughs and Special Industries

Attachment:

G.C.M. 34,721